

CalPERS Special Review: Selected Recommendations

I. Overview

Over the last year, CalPERS and its special review, led by Steptoe & Johnson LLP, have been actively investigating and addressing issues raised by the use of placement agents to determine whether the interests of participants and beneficiaries were compromised by the payment of placement agent fees and related activities. That work has been guided, in good part, by Article XVI, Section 17 of the California Constitution, as well as Section 20151 of the California Government Code, which provide that the CalPERS Board of Administration, its executive officers and other employees are to discharge their duties solely in the interest of CalPERS participants and beneficiaries, for the exclusive purpose of providing benefits to participants and their beneficiaries, defraying reasonable expenses of administering the system, and investing with the care, skill and diligence of a prudent person.

In the context of the special review, we have summarized these requirements into two categories: fitness and fees. With regard to fitness, our inquiry has focused primarily on whether CalPERS Board members, officers and employees have lived up to the high standards imposed upon them. We have also been considering qualitative fitness issues regarding the external money managers that serve CalPERS and support its investment process and objectives. With regard to fees, our inquiry has focused primarily on whether, during its investment process, CalPERS was misled or made to overpay, resulting in increased expenses and, ultimately, harm to the system's participants and beneficiaries.

As we approach the final stages of our review, we offer the following organizational and operational recommendations as they relate to placement agents and associated activities. These recommendations are intended to address issues we have observed with regard to fitness, fees and related requirements. Over the last year, CalPERS has taken significant steps in implementing many of these recommendations. To that extent, our comments here are intended to provide a framework to support those good actions. Our expectation is that the remaining recommendations will also be embraced by CalPERS Board members and management as the institution strives to implement a more modern governance model and set a standard for other public pension funds to follow.

II. Selected Recommendations

A. Recommendations Relating to Fitness Component of Special Review

Issues relating to the fitness of certain former CalPERS Board members, officers and employees have been reported widely in the press over the last year and will be discussed when the special review is completed. In the interim, selected related issues affecting the organization and operation of CalPERS are outlined below, along with observations and recommendations.

All of these recommendations share the common goal of maintaining an environment in which the many talented and dedicated employees of CalPERS may proudly perform their duties on behalf of members and beneficiaries without the ongoing cloud of ethical lapses caused by a relative few former Board members, executives and employees.

1. Institutional Risk Management and Oversight

Observation: The controversy involving placement agents and related activities has posed significant financial and reputational risks to CalPERS as an institution. Historically, no one at CalPERS has had exclusive responsibility for managing institutional risk or handling ethics concerns expressed by staff and Board members. Instead, that responsibility was spread across different offices and officers including the Chief Investment Officer, the Chief Compliance Officer, the Chief Executive Officer, and the General Counsel and Legal Office. Corporations and other institutions have come to recognize the importance of comprehensive risk management at the executive level. There is also a growing recognition of the benefits of a centralized office, with a single responsible executive, to address risk on an institution-wide basis. In the best cases, those officers are also overtly designated to address ethics concerns expressed by employees and have responsibility, and the resources and other support, to address them.

Institutions have also come to appreciate the merits of assigning to a single committee of their Boards of Directors or Trustees the responsibility for oversight of the institution's risk management function. Historically, however, no single committee of the CalPERS Board of Administration has been vested with this responsibility.

Recommendation: CalPERS and its leadership have been carefully considering the best operational structure to give sufficient attention to risk management, including ethics oversight. CalPERS recently created the position of Chief Risk Officer with overarching responsibility for risk management across all of its offices. That officer is also intended to serve as the lead point of contact for employees with ethics concerns, and a hotline has been established to facilitate reporting. Given the importance of the Chief Risk Officer's work, and to alleviate the need for reporting relationships to every committee of the board, we also recommend that the CalPERS Board assume formal oversight responsibility for the risk management function of the organization either by creating a separate and standing risk management committee, or by assigning the regular review of risk management matters to the oversight portfolio of an existing committee of the Board.

2. Gifts and Travel

Observation: During the course of our investigation, we learned that external money managers and others, including placement agents, paid for expensive meals and provided substantial gifts to CalPERS staff and Board members. Some of these meals and gifts were not reported on the required forms. We also learned that, until 2008, external managers made and paid for extraordinary travel arrangements, including air travel by private jet, for various CalPERS staff and Board members. This travel was not reported on the required gift forms, in some cases because it was provided pursuant to clauses in agreements between CalPERS and its investment

managers which specified that their investment partnerships were to pay for those trips. Gifts, meals and travel of this kind may create potential fitness issues and conflicts of interest, or at least the appearance of them, and suggest that decisions could be made for reasons other than the merits of a particular investment. No gift, meal or trip is worth compromising the integrity of the CalPERS investment process, or creating an appearance that it has been compromised.

Recommendation: We recognize that CalPERS now requires investment staff members to adhere to stringent new policies when traveling for meetings with investment managers. We also support the ban on gifts adopted by CalPERS regarding its staff, and recommend that this step be reinforced by enhanced training and certifications and that similar policies be adopted to apply to its Board members. Failure to comply with CalPERS gift and travel policies should have disciplinary consequences not only for staff or Board members, but also for the external manager or other firm in question. Going forward, either contractually or by regulation or legislation, any firm involved in two or more violations of these gift and travel policies should be prohibited from doing business with CalPERS for a period of not less than two years.

3. Certain Post-CalPERS Employment of Board Members and Staff

Observation: As the largest pension fund in the country, CalPERS has contracts or other arrangements with hundreds of external investment managers and contractors. California law currently permits former CalPERS Board members and employees to go to work for these external managers or contractors, without delay, so long as they do not immediately represent these firms before CalPERS. Although important, that proscription does not prevent a CalPERS Board member or employee from putting the interests of external managers, other contractors or their agents ahead of CalPERS in the hope of securing subsequent employment or similar consideration that does not require representation before CalPERS. Federal law, by contrast, imposes a “cooling-off period” on federal employees who award or manage contracts in excess of \$10 million, and does not permit immediate employment with the recipients of such contracts.

Recommendation: A company doing significant business with CalPERS (or an agent of such a company) should not be permitted to hire, immediately upon their departure from CalPERS, former Board or staff members who materially participated in decisions relating to that company. To that end, we recommend that CalPERS call for legislation going beyond the minimum requirements of California law and adopt a “cooling-off period” for its former Board and staff members similar to that provided under federal law. Specifically, a CalPERS Board or staff member should be prohibited from working for any company or its agents during a two-year period after termination of Board service or employment if, within the previous five years, CalPERS had an agreement with that company (including an agreement to manage funds on behalf of CalPERS) that exceeded \$10 million in value and that Board or staff member was materially involved in awarding or managing that agreement or investment. Moreover, a Board or staff member should be prohibited from working for any placement agent during the cooling-off period if that placement agent placed an investment with CalPERS during the previous ten years and regardless of whether the Board or staff member was materially involved in the decision to invest.

4. Responsiveness to Public Records Act Requests

Observation: The press has served a critical role in educating CalPERS participants and beneficiaries, as well as the public at large, about issues regarding placement agents and related activities. Prompt and adequate attention to Public Records Act requests plays an important part in ensuring the ongoing fitness of the operation and organization of CalPERS. At times, and often due to the sheer volume of requests (recently, regarding placement agents, for example), the staffing of Public Records Act responses has not been adequate. In addition, staff members occasionally have been put in the position of overseeing requests for documents in matters where they were materially involved.

Recommendation: Recognizing the importance of responding to public record requests and producing those documents that can and should be released, we recommend that additional staff be trained and dedicated to these tasks. It is also important that sufficient staff be dedicated to these tasks so that staff members who bear operational responsibility for the issues that are the subject matter of the underlying request are not also primarily overseeing or writing the final response to the public records request.

5. Internal Audit Program

Observation: The special review has also identified weaknesses that impaired the effectiveness of the CalPERS Office of Audit Services, its internal audit function. In particular, conclusions reached by the audit staff were occasionally overlooked and recommendations were not always implemented, especially with respect to audits of travel expenditures.

Recommendation: The Office of Audit Services and its staff dedicate substantial resources to their investigations. Their efforts should be recognized by implementing a reporting relationship that ensures that recommendations are considered by the highest levels of the institution, and that maintains the independence that the sensitive functions of this office demand. We recommend, therefore, that the Office of Audit Services report regularly to the CalPERS Board. We also recommend that there be greater accountability and timely resolution of findings by managers in response to internal audit findings and recommendations, and regarding travel expense matters in particular. We encourage the new Chief Risk Officer to play an active role in this effort as well.

B. Recommendations Relating to Fees Component of Special Review

External money management fees constitute the largest recurring expense for CalPERS. It was and remains, in the first instance, the responsibility of CalPERS staff and its investment consultants to negotiate and monitor these types of fees. At least in hindsight, the excessive nature of some of these fees created an environment in which external managers were willing and able to pay placement agent fees at a level that bore little or no relationship to the services apparently provided by the placement agents. Further, in some cases, placement agent fees were paid for new investments even though the external managers had existing relationships with CalPERS and, at times, even though there were apparently no additional services provided by the placement agent. In a sense, many of the abuses relating to placement agent arrangements were

merely a symptom of a larger problem relating to the prudence of certain external manager fees paid by CalPERS.

For this reason, the fee component of the special review has focused on whether CalPERS was made to overpay or bear increased costs that reduced investment returns for the pension fund. In the course of addressing these issues, CalPERS, through the special review, obtained over \$200 million in fee concessions from external managers in various asset classes. Following those results, CalPERS investment staff later secured an additional \$100 million in fee reductions from a number of other large external money managers. This should be the beginning, not the end, of efforts to ensure a close alignment of interests between CalPERS and the external money managers that it entrusts with pension plan assets.

Fairly addressing the issues associated with the use of placement agents requires an examination of not only the conduct of external managers but also the perceptions that shaped that conduct. To be clear, not all of the blame for the use of placement agents rests with external managers. There was a perception among a number of investment managers that the CalPERS investment office was not accessible without such assistance. The investment office now plainly understands the problems that this perception created and its Chief Investment Officer has stated publicly that placement agents are not necessary to secure capital commitments from CalPERS. A recent step to improve access for potential new external managers is the implementation of a direct line to the investment office for the submission of proposals, and dedicating staff to ensure that each proposal is duly considered.

The recommendations below address additional systemic issues observed in connection with the fee component of our review. The goal of all of these recommendations is to improve the prudence, integrity and transparency with which the CalPERS investment function operates.

1. Relationships Between External Managers or Contractors and Placement Agents

Observation: Consistent with its leadership position as the largest public pension fund in the United States, CalPERS set the standard for obtaining disclosures from all of its external money managers regarding their use of placement agents. In the spring and summer of 2009, CalPERS implemented a comprehensive program, later augmented by the efforts of the special review, to obtain disclosure of the nature and terms of the relationship between every one of its external managers and any placement agent. In the course of our investigation, we also learned that placement agents or others with similar responsibilities have been used by firms other than external managers to secure contracts from CalPERS.

Recommendation: Over the last year, the CalPERS Board developed and approved placement agent policies that were instrumental in forming the basis for legislative bill AB 1743, which CalPERS strongly supported and was signed into law in California on September 30, 2010. That law regulates placement agents and, in particular, subjects placement agents to the same registration and disclosure regulations that apply to lobbyists. CalPERS should continue to ensure that its policies and the provisions of the new law are fully implemented. Also, because any company doing business with CalPERS could employ a placement agent, we have

recommended, and CalPERS has agreed, that standard language should be included in every Request for Proposal issued by CalPERS requiring the disclosure of any third-party agent or consultant used in connection with the proposal and the terms of that arrangement.

2. Relationships with External Managers that Paid Placement Agents

Observation: CalPERS, through its special review, has worked with several external managers to realign their relationships with the institution in a precedent-setting fashion. Recognizing the difficulties that arose from their use of placement agents, and consistent with their leadership in the financial industry, these elite firms agreed to a total of over \$200 million in fee reductions for CalPERS. They also agreed to no longer use placement agents for new CalPERS investments as well as additional safeguards. There are other firms for whom CalPERS has decided that no agreement could provide the necessary safeguards, and CalPERS has decided to either terminate those relationships or not enter future relationships with those firms. There is a third group of firms, however, that have outstanding issues relating to placement agents (albeit for smaller amounts) that have not yet been addressed but merit further pursuit by the institution.

Recommendation: CalPERS should implement a “placement agent resolution program” to allow those managers that paid placement agents to resolve outstanding issues in a manner consistent with the precedents set by the other agreements recently entered into by CalPERS. Where managers with outstanding placement agent issues decline to cooperate, CalPERS should not consider new investments with those managers. In certain cases, CalPERS may need to end existing business relationships. CalPERS must be able to trust that its managers act in the best interests of its participants and beneficiaries when managing money for CalPERS. Refusing to address outstanding placement agent issues violates that trust and signals a desire to put the interests of the external managers ahead of those of CalPERS. The investment office should regularly report to the Board on the progress being made with external managers on their outstanding issues regarding placement agents.

3. Continued Alignment of Interests of CalPERS and Its External Managers

Observation: CalPERS is an investor of choice for most money managers. Securing an investment from CalPERS often serves as a calling card that managers use to secure investments from other large institutional investors. Nonetheless, over the years, CalPERS often simply accepted what it believed were market terms or conditions, rather than using its size and reputation to secure the best possible terms on fees it pays to have its money managed. We have also noted a proliferation of secondary fees charged atop the core incentive and management fees paid to external money managers. Given the substantial incentive and management fees that these external managers may earn, these other fees appear to be an unnecessary source of profit from CalPERS. The scale of these profits were an apparent excess that helped allow for the payment of placement agents.

Recommendation: CalPERS should sustain its renewed focus on negotiating lower management fees with all of its existing external managers and, from every investment relationship possible, eliminate incidental and other fees including monitoring fees, deal fees and similar transaction fees. To better align the interests of CalPERS with those of its external managers going forward, CalPERS should insist that nearly all of the fees it pays be in the form of incentive fees paid based on the success of its external managers in investing CalPERS assets and not in management or other fees. To assist in this effort, all fees should be documented in a transparent and straightforward manner at the time the investment is first proposed.

4. Payment of Placement Agent Fees from Investment Funds

Observation: Investments made by CalPERS through private equity or real estate firms are typically structured as partnerships in which CalPERS and other investors are limited partners. The firm offering and managing the investment is usually the general partner. It was apparently common for the partnership as a whole, rather than the general partner, to pay the cost of fees for placement agents using funds intended for investment. As a result, and notwithstanding later offsets against management fees paid to the general partner, CalPERS as a limited partner initially paid for placement agents whose role benefited only the general partners and not CalPERS. While there is disagreement, many believe that this practice raised the cost of these funds and reduced investment returns. As important, this practice of offsetting placement agent payments against future management fees also apparently benefited general partners by allowing them to effectively deduct for tax purposes otherwise nondeductible expenses, like placement agent fees. This, in turn, may have increased the amount the general partners were willing to pay to placement agents.

Recommendation: CalPERS should adopt policies that prohibit the direct or indirect payment of placement agent fees from the assets of the partnerships or other funds in which it invests. Such fees should not be paid in connection with a CalPERS investment and, insofar as they may be incurred elsewhere, should be paid directly and exclusively by the general partners managing these funds.

5. Expenses for Annual, Advisory Board and Other Meetings

Observation: Despite the economic downturn, investment fund annual meetings and periodic advisory board and other meetings called by external money managers continue to be held in unduly lavish locations and often involve expensive dinners and entertainment. The expenses associated with these meetings are usually borne by the partnership through funds intended for investment, and increase the costs associated with these funds by decreasing the amount available for investment, ultimately reducing investment returns for CalPERS. While important, the business conducted at these meetings can be done in more modest settings.

Recommendation: Lavish meetings are inconsistent with the mission of CalPERS to prudently invest and manage its trust funds. CalPERS recently acted to limit these excesses by prohibiting its staff from attending entertainment events and meals held apart from business meetings. That is a good first step. Going forward, CalPERS should encourage its external managers to hold all

of these meetings, including annual and advisory board meetings, at the offices of one of the limited partners, including its own in Sacramento, or at the general partner's offices. We recommend that, to facilitate this change, CalPERS should direct its staff to only attend meetings held at those locations. We also recommend that the general partner, and not the partnership, bear the cost of these meetings and that this change be imposed in every current and future investment agreement involving CalPERS.

6. Avoiding Potential Conflicts in Investment Functions

Observation: In addition to its internal investment staff, CalPERS also employs outside investment consultants. These consultants are expected to provide independent and objective advice to CalPERS for a fee. Outside consultants often provide opinions on the prudence of proposed investments, and monitor those and other investments once they are made. Some of these consultants also have been allowed to act as external investment managers for CalPERS. Allowing these investment consultants to play multiple roles of this kind has not always served CalPERS well. In addition, important roles within the CalPERS investment office are shared among staff members wearing multiple hats on the same transaction or with respect to the same investment manager. For example, a staff member in the CalPERS investment office may be responsible for negotiating with external managers and have a mandate to pursue terms that are most favorable to CalPERS. However, that same staff member may also later direct and oversee the relationship with that external manager once the negotiations have concluded. The necessarily adverse positions that the staff person may need to take during negotiations may impair that staff person's ability to foster the cooperative relationship that is later needed to properly manage the investment and ensure that the best returns are achieved.

Recommendation: CalPERS values the roles played by its investment staff and outside consultants, but to ensure objectivity at all stages of the investment cycle, CalPERS should more clearly separate investment functions inside and outside its investment office. Inside the investment office, a chief negotiator or negotiators should be tasked with the responsibility of negotiating all contracts with external managers while other staff assume responsibility for the monitoring and maintenance of those relationships. Further, outside consultants should only be permitted to fulfill one of two functions with respect to a given investment: either providing opinions on the prudence of an investment being considered by CalPERS, or assisting in the monitoring of the investment once made by CalPERS, but not both. Most important, outside investment consultants should never be permitted to also serve as external money managers for CalPERS.

7. Employees Performing Key Investment Functions

Observation: Staff in the CalPERS investment office manage more than \$200 billion of public money and some are among the most highly paid public employees in the State of California due to exceptions from the general civil service pay scales. That compensation is appropriate in light of their responsibilities to manage large sums of money, and the salaries for comparable jobs in the private sector. Notwithstanding their substantially higher compensation compared to other public employees, however, investment office staff are still subject to the general state civil

service rules regarding progressive discipline and termination. In fact, they are paid higher salaries and afforded more civil service rights than even some of CalPERS' most senior executives. While the investment office staff's compensation is higher and can rise further based on investment performance, state civil service rules regarding progressive discipline and termination prevent CalPERS from acting as quickly as might otherwise be appropriate when these staff members fail to discharge their duties as they should.

Recommendation: In the event that highly paid investment office staff do not perform as expected, CalPERS should be able to take disciplinary action more quickly and not have to bear the expense of their high salaries through the normal progressive discipline and termination process generally applicable to civil service employees. To that end, CalPERS should propose to the California legislature and seek the adoption of legislation that substantially streamlines the discipline process for CalPERS investment staff at the portfolio manager level and above, and allows for substantial downward adjustments in their salaries to general civil service pay scales during the discipline and termination process.

* * *

Philip S. Khinda
Donald E. Wellington
Steptoe & Johnson LLP

Ellen S. Zimiles
Navigant Consulting, Inc.